<u>After 12 Years of Change Congress Brings Some Permanent Stability to the Estate Tax</u>

Back in November, with the fiscal cliff looming in the distance, it was anyone's guess what the effect of any congressional negotiations would be on the estate tax. One of those doing the guessing was me, and I wrote about my predictions for the 2013 here. As it turns out, those weren't that far off from reality (though in fairness, they were based on President Obama's proposed budget). On New Year's Day, after more bickering than most of the general population cares to see out of elected officials, the House approved a Senate plan to avoid going over the cliff. Thanks to congressional action, there is now a clear picture of the estate tax for 2013 and beyond.

Here are seven key points on the new law:

1. The Exemption Amount

Back in November it looked like there was a good chance that Congress would permanently extend the exemption amounts in place in 2012. Up through 2012, the gift tax and estate tax were unified, meaning, generally, that the exemption could be used for gifts during life or bequests at death.

Last year, the exemption amount was set at a unified rate of $5 million (including accumulated gifts and estate value). Now, the $5 million exemption amount is in place for the foreseeable future. That amount is indexed for inflation which means an exemption amount of $5.25 million in 2013. Unification of the gift and estate taxes has also been made permanent. The consequence of which is that planners have a great amount of flexibility when it comes to structuring estate plans to transfer wealth while minimizing tax consequences.

Individuals can also gift up to $14, 000 ($28,000 per married couple) to an unlimited amount of individuals tax free each year.

2. Estate Tax Rate

Back in November, I noted that the president's proposed budget would call for a 45% tax rate on any amounts above the exemption amount- up from the 2012 rate of 35%. Evidently, congress took a middle-of-the-road approach and settled on a 2013 rate of 40%. As I noted in November, a lower tax rate (in theory) reduces the tax owed for all taxable estates but saves the most money for the largest estates. This middle-of-the road approach preserves that idea while still raising revenue based on a higher estate tax rate, though when considered in the grand scheme of U.S. economic policy, the 5% increase represents a relatively nominal change.

While some may cringe at the notion of raising the estate tax rate (the "death tax" as its detractors lovingly refer to it) and argue that 35% was much too high to begin with, it's important to remember that as recently as 2001, the top rate was 55%- a much more bitter pill to swallow.

3. Portability

Portability was a tremendously beneficial planning tool for spouses in 2012. Portability refers to the ability of a surviving spouse to use the exemption amount of the deceased spouse upon her death.

For illustration purposes say Husband and Wife have $6 million in total assets and their individual wills transferred all assets to the surviving spouse. If Husband dies in 2013, Wife would inherit all of his assets without incurring any federal estate taxes (due to the ability of spouses to transfer unlimited assets to each other tax free). At this point all is well and good. However, without portability, Husband's estate tax exclusion has now been wasted. When Wife dies a year later, her $6 million estate will be subject to estate tax since she is only permitted to exempt the first $5 million of value from tax. This means that, without portability, Wife's estate would pay estate taxes at a rate of 45% on $1 million- Enter sad beneficiaries.

But, look at the same example with portability. When Husband dies in 2013, all of his assets pass to Wife tax free just like the first example. However, now, portability will allow Wife to carry over Husband's exemption amount and preserve it. When Wife dies in 2014 not only can she use her exclusion but she can use Husband's unused exclusion as well (for a total exclusion amount of $10 million) enabling her to pass the entire $6 million estate to the chosen beneficiaries free of federal estate tax.

The good news for married couples is that congress elected to make portability permanent, increasing a couple's ability to pass substantial amounts of wealth on to children or other loved ones with minimal tax liability.

4. Basis step-up rules remain intact

The president's proposal would have required recipients of substantial gifts or estates to limit their basis in any received gift or inheritance to that used by the donor. That would limit a recipient's ability to lower capital gains by claiming a higher basis. However, the basis step-up rules have remained largely intact.

As an example, assume that Father owns some stock with a cost basis of $20 a share. Upon his death, Father bequeaths the stock, which is now worth $50 a share, to Son. Under the president's proposal, son would receive the stock with an assigned basis of $20 per share- the same as Father's basis in the stock. Upon any sale, Son would need to pay capital gains on any amount realized over the $20 per share. However, with a permitted step up in basis, upon Father's death, Son would receive the stock with whatever its basis was at the date of Father's death- here, $50. Upon a subsequent sale, Son would only pay capital gains on any amount realized over the $50, effectively giving him $30 of value in each share tax free.

5. Modifying rules on valuation discounts

Valuation discounts have been commonly used in the past to reduce the tax payable on transfers of interests in family controlled entities. President Obama's strong preference was to substantially limit their use as a tax-avoidance mechanism; however, the new law does not contain any restrictions on the applicability of valuation discounts to transfers of family business interests.

6. Requiring a minimum term for grantor-retained annuity trusts

Grantor Retained Annuity Trusts (GRATs) are a mechanism by which an interest in a trust is transferred to a family member whereby the creator of the trust receives an annuity off of the transferred assets for a specified period of time. The key, however, is that the creator of the trust who is receiving the annuity must outlive the chosen annuity period in order to see the tax savings.

Back in November, it was noted that the president sought to set a minimum time frame on these trusts increasing the risk that the trust creator would die during its term, thereby subjecting the assets to estate tax. However, those concerns seem to have fallen on deaf ears, as Congress did not include any new restrictions or limitations on the use of GRATs. They remain a powerful planning tool for maximizing tax-free gifts.

7. Extending the Lien on Estate-Tax Deferrals Provided under Section 6166 of the Internal Revenue Code

Estates that are structured around closely held business interests have the ability to defer payment of any estate tax for up to 14 years under the theory that the significant tax payments could detrimentally affect the business. However, there is a risk that any business afforded that protection could fail within that 14 year period. Up through 2012, a tax lien could be placed on the estate to recover the amount owed, but those liens expire before the 14 year period expires.

The president wanted to modify the lien period to coincide with the deferral period giving the government possible recourse in the event of a default; however, that will have to remain a battle for another day, as congress did not address the proposed modification.

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